INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument	6
Conclusion	13

CITATIONS

Cases:

American Mfg. Co. v. *United States* (E.D.N.Y., Civ. No. 68-C-1096)	9
American National Bank of Austin v. *United States*, 421 F. 2d 442, certiorari denied, October 12, 1970, No. 168, this Term	13
Berkowitz v. *United States*, 411 F. 2d 818	13
Commissioner v. *Court Holding Co.*, 324 U.S. 331	11, 13
Commissioner v. *Duberstein*, 363 U.S. 278	12, 13
Commissioner v. *Gordon*, 391 U.S. 83	10
Goldstein v. *Commissioner*, 364 F. 2d 734, certiorari denied, 385 U.S. 1005	8
Gregory v. *Helvering*, 293 U.S. 465	7
Knetsch v. *United States*, 364 U.S. 361	8
Lanvin-Charles of the Ritz v. *Commissioner* (T.C. No. 5950-70)	10

Cases—Continued	Page
Minnesota Tea Co. v. *Helvering*, 302 U.S. 609	7
Motor Finance Corp. v. *United States* (N.J., Civ. No. 748-67)	10
National Industries v. *Commissioner* (T.C. No. 3690-69)	10
Union Planters Nat. Bank of Memphis v. *United States*, 426 F. 2d 115, certiorari denied, October 12, 1970, No. 331, this Term	13
United States v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451	11, 12
United States v. *General Geophysical Co.*, 296 F. 2d 86, certiorari denied, 369 U.S. 849	7
United States v. *Mississippi Valley Co.*, 364 U.S. 520	11
Statutes:	
Internal Revenue Code of 1954 (26 U.S.C.):	
Sec. 316	10
Sec. 355	10
Miscellaneous:	
Treasury Regulations on Income Tax (26 C.F.R.):	
Sec. 1.1502-31A	3, 8, 9

In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1085

WATERMAN STEAMSHIP CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 30-61) is reported at 50 T.C. 650. The opinion of the court of appeals, reversing the decision of the Tax Court (Pet. App. 2-29), is reported at 430 F. 2d 1185.

JURISDICTION

The judgment of the court of appeals was entered on July 15, 1970 (Pet. App. 73-74). A petition for rehearing and petition for rehearing *en banc* were denied on September 17, 1970 (Pet. App. 1-2). The

petition for a writ of certiorari was filed on December 11, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals correctly held that a $2,799,820 promissory note, transferred to petitioner from one of its two subsidiaries, was not in substance a tax-free intercompany dividend, but actually was part of the $3,500,000 purchase price received by petitioner on the sale of its stock in the subsidiaries, when the parties had prearranged that the funds for the payment of the purported "dividend" note would be furnished by the purchaser of the stock immediately after consummation of the sale.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 316, 1501 and 1502 of the Internal Revenue Code of 1954 and of Section 1.1502-31A of the Treasury Regulations on Income Tax are set forth in the Appendix to the petition (Pet. App. 65-67, 69-71).

STATEMENT

During 1954 and until May 5, 1955, petitioner was a publicly-held corporation engaged in the steamship business. It was the sole owner of two subsidiaries, Pan-Atlantic Steamship Corporation ("Pan-Atlantic") and Gulf Florida Terminal Company, Inc. ("Gulf Florida"). Petitioner and its subsidiaries filed consolidated income tax returns for the period

January 1, 1955 through May 5, 1955, with Pan-Atlantic included in the affiliated group until January 21, 1955. (Pet. App. 4-5.)

In 1954, Malcom P. McLean ("McLean"), the majority stockholder of McLean Trucking Company ("Trucking"), became interested in acquiring the assets of petitioner and/or its subsidiaries. Having been advised, however, that Interstate Commerce Commission approval would be required if he were to make an acquisition of assets, McLean made a written offer to purchase all of petitioner's stock (instead of the assets) in Pan-Atlantic and Gulf Florida for $3,500,000 cash. (Pet. App. 5-6.)

Since petitioner's basis in the stock of its two subsidiaries totalled $700,180, a sale for $3,500,000 would have produced a taxable capital gain of approximately $2,800,000. Petitioner's president, motivated primarily by the tax consequences, therefore opposed acceptance of the offer in the form suggested by McLean. He advised the board of directors, however, that the capital gains tax could be avoided if, prior to the sale of the stock, one of the subsidiaries were to pay petitioner an intercompany dividend totalling $2,800,000.[1] Accordingly, the directors rejected the offer and made a written counterproposal to sell to McLean (or his nominee) all of the Pan-Atlantic and Gulf Florida stock for $700,000 cash, but only after the directors of the subsidiaries had de-

[1] The Treasury Regulations on consolidated returns (Sec. 1.1502-31A(b)(1)(i) and (2)(ii)) provide that dividends received from affiliated corporations are excludable from income.

cleared and arranged for payment of dividends to petitioner in the aggregate amount of $2,800,000. (Pet. App. 6-7.)

During the next month, discussions and negotiations ensued between the officers of petitioner and representatives of McLean. At the same time, McLean took several steps to ensure that ICC approval would not be required for the acquistion.[3] On January 14, 1955, Trucking organized McLean Securities Corporation ("Securities"), which thereupon issued to Trucking one million shares of its common stock. On January 17, Trucking paid as a dividend one share of Securities stock for each share of the one million outstanding shares of Trucking. Having received 580,000 shares of Securities as a result of the dividend, McLean then purchased 190,000 additional shares to bring his holdings in Securities to 770,000 shares. He also arranged to place his (and his family's) Trucking stock in an irrevocable management trust immediately prior to the stock purchase. (Pet. App. 8-9.)

On January 21, the parties gathered at petitioner's offices to consummate the sale of the stock. Various events took place in the following time sequence:

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[3] ICC approval would have been required for an acquisition of assets, inasmuch as petitioner, its subsidiaries and Trucking all held ICC certificates. McLean's control of Trucking also prohibited his acquiring control of another carrier without ICC approval. McLean was advised, however, that he could bypass the ICC if he divested himself of control of Trucking (by a management trust) and acquired the stock, instead of the assets, of Pan-Atlantic and Gulf Florida. (Pet. App. 5-6.)

At noon, Pan-Atlantic declared a "dividend" of $2,799,820, payable to shareholders of record on January 20, 1955.[3] Since Pan-Atlantic did not have sufficient cash to pay the dividend and was unable to distribute any of its assets, the dividend was declared in the form of a $2,799,820 promissory note, payable on or before February 20, 1955. (Pet. App. 10.)

At 12:30 p.m., the directors of Securities met and authorized the purchase of the stock in the two subsidiaries (Pet. App. 11).

At 1:00 p.m., the directors of petitioner met and approved the sale of the Pan-Atlantic and Gulf Florida stock for $700,180. When he was informed of the board's approval, McLean executed a trust agreement divesting himself of control of Trucking. The closing agreement for the sale of the stock was then executed, with Securities guaranteeing the prompt payment of the $2,799,820 "dividend" note and paying the $700,180 "purchase price" to petitioner. (Pet. App. 11-12.)

At 1:30 p.m., the new board of directors of Pan-Atlantic met and authorized the borrowing of $2,500,000 from McLean personally and $299,820 from Securities. Immediately thereafter, Pan-Atlantic issued a check to petitioner for $2,799,820 in payment of the promissory note which Pan-Atlantic had issued to petitioner as a "dividend." The net result of the day's activities, all occurring within ninety minutes, was that petitioner had received $3,500,000 cash, all emanating from Securities and

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[3] As of January 21, Pan-Atlantic had earnings and profits of at least $2,799,820. But it had no cash with which to pay a dividend. (Pet. App. 10.)

McLean, the buyers of the stock, without extracting any of the assets of Pan-Atlantic or Gulf Florida. (Pet. App. 12-13.)

On its consolidated income tax return, petitioner eliminated from income the $2,799,820 received in the form of a "dividend" from Pan-Atlantic and reported only $700,180 as the sales price of the stock in Pan-Atlantic and Gulf Florida. The Commissioner asserted a deficiency on the ground that the $2,799,820 promissory note was in substance part of the agreed-upon purchase price for the stock sold and that petitioner had consequently realized a long-term capital gain of $2,799,820. (Pet. App. 13-14.)

Petitioner thereafter instituted this suit in the Tax Court, which found (with four judges dissenting) that the note reflected a true dividend because it had been paid before equitable, beneficial, or legal ownership passed to the purchaser of the stock (Pet. App. 59). On appeal, the Fifth Circuit reversed (*id.*, pp. 2-29) holding (*id.*, p. 17) that, in substance, Pan-Atlantic neither declared nor paid a dividend to petitioner, but rather acted as a mere conduit for the payment of the purchase price.

ARGUMENT

The decision below is correct. There is no conflict of decisions or any other reason for further review by this Court.

1. The conclusion of the court of appeals that, in substance, Pan-Atlantic neither declared nor paid a dividend to petitioner is the only conclusion compatible with the uncontroverted facts of this case. McLean

offered to pay petitioner $3,500,000 for the stock of its two subsidiaries and McLean did, in fact, pay petitioner $3,500,000. Petitioner never extracted any assets of Pan-Atlantic or Gulf Florida prior to the sale and, as a practical matter, it could not have done so, since neither subsidiary had the requisite cash or unwanted assets to make a genuine distribution of accumulated corporate earnings. The $2,799,820 promissory note, which the parties labelled as a dividend, had a life of less than two hours and, in keeping with a prearranged understanding, it was paid by interests controlled by McLean immediately after the sale had been consummated. Given these facts, each of which appears in the Tax Court's findings (Pet. App. 30-44, 47-50), the court of appeals aptly characterized the declaration and payment of the dividend "note" as (*id.*, p. 3) "an attempt by a taxpayer to ward off tax blows with paper armor."

In reaching its ultimate conclusion, the court of appeals neither misconceived the applicable law nor subverted the congressional policy with respect to the tax treatment of intercorporate distributions, as petitioner suggests (Pet. 9-14). Rather, it scrutinized a transaction heavily freighted with tax avoidance motives in the context of the fundamental principle that tax consequences must turn upon the economic substance rather than the timing sequence or mere form of the transaction in issue. See, *e.g.*, *Gregory* v. *Helvering*, 293 U.S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609; *United States* v. *General Geophysical Co.*, 296 F.2d 86 (C.A. 5), certiorari denied, 369 U.S. 849. The short life of the dividend "note,"

the fact that it was ultimately financed by McLean, and the indication that no dividend would have been paid but for the contemplated sale, were only a few of the factors which led the court of appeals to disregard the dividend distribution as a "sham." Nevertheless, even if the court had believed that the fleeting "dividend" indebtedness was genuine, application of the proper legal standards would have required that it be disregarded for tax purposes, since it is apparent that the transfer of the promissory note had no purpose, substance or utility apart from petitioner's desire to secure a tax benefit.[*] *Knetsch* v. *United States*, 364 U.S. 361; *Goldstein* v. *Commissioner*, 364 F.2d 734 (C.A. 2), certiorari denied, 385 U.S. 1005.

Petitioner's contention (Pet. 11-12) that the holding below threatens the policy behind the intercompany dividend exclusion is incorrect. Although no one disputes that the cited Regulations (Sec. 1.1502-31A (b)(1) and (2)) aim to tax the correct taxable income of an affiliated group of corporations as if they were in reality one and the same business, Congress never intended to exempt profits from transactions

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[*] Petitioner's claim (Pet. 13) that non-tax factors necessitated that the transaction be cast as it was is misleading. Petitioner overlooks the fact, recognized by the court of appeals (Pet. App. 24-25), that while ICC approval would have been required had McLean acquired the assets of petitioner or its subsidiaries, there was no requirement by the ICC or anyone else (except petitioner) for dividing the stock sale into two parts, labelling one aspect a "dividend" and the other the "selling price." As for petitioner's suggestion that it might have realized an actual loss on the sale of its assets, the simple answer is that petitioner sold its stock, not its assets, and the proper focus here is on what was actually done by the parties.

outside the affiliated group.[5] Where, as in this case, all the funds passing to the taxpayer emanated from an outside source (which was purchasing the stock of the taxpayer's subsidiaries), and the subsidiaries themselves had insufficient funds of other unwanted assets to distribute as dividends, the preferential treatment provided for genuine intercorporate distributions is not warranted. At all events, the court of appeals pointed out (Pet. App. 29) that its decision need not be interpreted as standing for the proposition that a corporation may not, under any circumstances, distribute a subsidiary's earnings and profits prior to a sale without having the distribution deemed part of the purchase price. It is clear that the holding below turned upon the special facts of the transaction between petitioner and McLean. Under these circumstances, petitioner's claim (Pet. 9-11) that this case has present administrative importance is groundless. Although petitioner asserts that sales and acquisitions of corporate subsidiaries and pre-sale extractions of earnings are occuring daily, it cites no decided cases which are at all analogous to the instant case.[6]

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[5] Evidence of the legislative purpose appears in the Treasury Regulations, Sec. 1.1502-31A(b)(1), which provides that:

> Intercompany profits and losses which have been realized by the group through final transactions *with persons other than members of the group*, and intercompany transactions which do not affect the consolidated taxable income shall not be eliminated. [Emphasis added.]

[6] *American Mfg. Co.* v. *United States* (E.D. N.Y., Civ. No. 68-C-1096) is no longer pending, having been settled in De-

2. Petitioner argues (Pet. 14-16) that the decision below conflicts with decisions of this Court, particularly *Commissioner* v. *Gordon*, 391 U.S. 83, on the question of what constitutes a distribution of property. The *Gordon* case is not in point. The issue there was whether a particular distribution by a corporation to its shareholders met the requirements of Section 355 of the Code, which accords favorable tax treatment to certain types of corporate divisions. Section 355 is not in issue here. The language from *Gordon* quoted by petitioner (Pet. 14-15), virtually a verbatim recitation of Section 316 of the Code, merely stands for the uncontested proposition that a "dividend" is any distribution of property by a corporation to its shareholders out of accumulated earnings and profits. But the question in this case is whether in substance Pan-Atlantic made a true distribution, and the subsidiary findings of the Tax Court preclude the conclusion that it did. The court of appeals would have ignored reality had it regarded this as a case where a corporation, about to sell the stock of a subsidiary, declares a true dividend prior

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cember, 1970. As for the other cases, only *Motor Finance Corp.* v. *United States* (N.J., Civ. No. 748-67) has been tried, with the major emphasis falling on issues unrelated to this case. In any event, as petitioner concedes (Pet. 10), in *Motor Finance* the dividend was paid by the subsidiary out of its own available cash rather than with funds furnished by the purchaser. Neither *National Industries* v. *Commissioner* (T.C. No. 3690-69) nor the recently-filed *Lanvin-Charles of the Ritz* v. *Commissioner* (T.C. No. 8950-70) has advanced beyond the pleadings stage. While both cases arguably involve factual offshoots of this case, it would be premature at this time to project any disparity of results.

to the actual sale, the effect of which reduces the price paid for the stock by the buyer.

3. Petitioner mistakenly asserts conflict (Pet. 16-19) regarding the scope of appellate review between the decision below and the decisions of this Court in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331, and *United States* v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451. The ultimate question in each of those cases—whether a sale of corporate assets was made by the corporation or by its shareholders in their individual capacity—was held to be a question of fact. That holding is not inconsistent with the decision below, since *Court Holding* and *Cumberland* turned on questions of motive, intent and conduct, which are unquestionably within the province of the trier of fact. Indeed, the determinative factor in those cases was held to be whether a meeting of the minds had been reached between the corporation and the buyers of the corporate assets prior to the decision to liquidate and distribute the assets to the shareholders. The essence of the two holdings is that where a subjective intent to effect a sale had been formulated between the corporation and the buyer, a subsequent liquidating distribution and "sale" by the shareholders would be disregarded. Unlike *Court Holding* and *Cumberland*, the subjective intent of the parties is not of controlling significance in this case, which hinges on the legal characterization of a transaction on the basis of uncontroverted underlying facts. The court of appeals was fully entitled to scrutinize the transaction, for as this Court stated in *United States* v. *Mississippi Valley Co.*, 364 U.S. 520, 526,

an appellate tribunal's "reliance upon the findings of fact does not preclude [it] from making an independent determination as to the legal conclusions and inferences which should be drawn from them."

For the same reasons, nothing in *Commissioner* v. *Duberstein*, 363 U.S. 278, also cited by petitioner (Pet. 16), is inconsistent with the decision below. In *Duberstein*, the Court held that the question whether a financial benefit received by a taxpayer is a gift or taxable compensation depends entirely on the subjective intent of the donor and therefore the findings of the trial court with respect to this purely factual question are subject to review on appeal under the clearly erroneous rule. This case, unlike *Duberstein*, does not fall within that area of law where the decision must be based ultimately on the "application of the fact-finding tribunal's experience with the mainsprings of human conduct" 363 U.S. at p. 289. The subjective intent of the parties is not material to the legal conclusions here, where we are concerned only with what was done, not why—or when—it was done.

In sum, in recognizing that it was not required to pay obeisance to the Tax Court's characterization of the transaction, the court of appeals did not depart from the accepted and usual course of legal proceedings, as petitioner suggests (Pet. 19). On the contrary, the decision is an example of the current, more realistic approach to appellate review, which recognizes the essential distinction between the determination of the various objective indicia of a commercial transaction (question of fact) and the determination as to how

these various economic facts should be characterized for federal tax purposes (question of law). See, e.g., *Union Planters Nat. Bank of Memphis* v. *United States*, 426 F.2d 115 (C.A. 6), certiorari denied, October 12, 1970, No. 331, this Term; *American National Bank of Austin* v. *United States*, 421 F.2d 442 (C.A. 5), certiorari denied, October 12, 1970, No. 168, this Term; *Berbowitz* v. *United States*, 411 F.2d 818 (C.A. 5). While the courts are not uniform in their acceptance of this current approach to the question of the scope of review, and while resolution by this Court may ultimately be necessary, the instant case does not present an appropriate vehicle for such review, and the alleged conflict between the scope of review herein and that in *Court Holding*, *Cumberland* and *Doberstein* does not exist.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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